purpose of the transaction is to avoid the provisions of this section by increasing the amount of loans for which deductions are allowable under the specific charge-off method. If this paragraph (d)(3) applies, the District Director may disregard the disposition for purposes of paragraphs (b)(1) and (d)(1) of this section or treat the replacement loans as pre-disqualification loans. If loans are so treated as pre-disqualification loans, no deductions are allowable under the specific charge-off method for the loans, except as provided in paragraph (b)(1) of this section, and the disposition that causes the loans to be so treated may be disregarded for purposes of paragraphs (b)(1) and (d)(1) of this section. If a bank sells pre-disqualification loans and uses the proceeds of the sale to originate new loans, this paragraph (d)(3) does not apply to the transaction.

(e) *Examples.* The following examples illustrate the principles of this section:

Example 1. Bank M is a bank that properly elects to use the cut-off method set forth in this §1.585–7. M's disqualification year is its taxable year beginning on January 1, 1987. On December 31, 1986, M had outstanding loans of $700 million (pre-disqualification loans), and the balance in its bad debt reserve was $10 million. M must maintain its reserve for its pre-disqualification loans in accordance with §1.585–7(b), and it may not deduct any addition to this reserve for taxable year 1987 or any later year. For these years, M may deduct amounts allowed under section 166(a) for loans that it originates or acquires after December 31, 1986, and that become worthless in whole or in part.

Example 2. Assume the same facts as in Example 1. Also assume that in 1987 M collects $150 million of its pre- disqualification loans, M determines that $2 million of its pre-disqualification loans are worthless, and M recovers $1 million of pre-disqualification loans that it had previously charged against the reserve as worthless. On December 31, 1987, the balance in M's bad debt reserve is $9 million ($10 million − $2 million + $1 million), and the balance of its outstanding pre-disqualification loans is $548 million ($700 million − $150 million − $2 million).

Example 3. Assume the same facts as in Examples 1 and 2. Also assume that on December 31, 1990, the balance in M's bad debt reserve is $5 million and the balance of its outstanding pre-disqualification loans is $25 million. In 1991 M collects $21 million of its outstanding pre-disqualification loans and determines that $1 million of its outstanding pre-disqualification loans are worthless. Thus, on December 31, 1991, the balance in M's bad debt reserve is $4 million ($5 million − $1 million), and the balance of its outstanding pre-disqualification loans is $3 million ($25 million − $21 million − $1 million). Accordingly, M must include $1 million ($4 million − $3 million) in income in taxable year 1991, pursuant to §1.585–7(c). On January 1, 1992, the balance in M's reserve is $3 million ($4 million − $1 million).

Example 4. Assume the same facts as in Examples 1 through 3. Also assume that in 1992 M transfers substantially all of its assets to another corporation (N) in a transaction to which section 381(a) applies, and N is treated as a large bank under §1.585–5(b)(2) for taxable years ending after the date of the transaction. Pursuant to §1.585–7(d)(2)(i), N steps into M's shoes with respect to using the cut-off method. M's bad debt reserve immediately before the section 381(a) transaction carries over to N, and N must complete the cut-off procedure begun by M. For this purpose, N's balance of outstanding pre-disqualification loans immediately after the section 381(a) transaction is the balance of these loans that it receives from M.

Example 5. Assume the same facts as in Examples 1 through 4, except that N is not treated as a large bank after the section 381(a) transaction. Also assume that N uses the reserve method of section 585 and plans to use this method for all of the loans it acquires from M (including loans that were not pre-disqualification loans). Pursuant to §1.585–7(d)(2)(ii), M's bad debt reserve immediately before the section 381(a) transaction carries over to N in the transaction; however, N does not continue the cut-off procedure begun by M and does not treat any loan as a pre-disqualification loan. If the six-year moving average amount (as defined in §1.585–2(c)(1)(ii)) for all of N's newly acquired loans exceeds the balance of the reserve that carries over to N, N increases this balance by the amount of the excess. Any such increase in the reserve results in a negative section 481(a) adjustment that is taken into account as required under section 381.

[T.D. 8513, 58 FR 68762, Dec. 29, 1993; 59 FR 15502, Apr. 1, 1994]

§1.585–8 Rules for making and revoking elections under §§1.585–6 and 1.585–7.

(a) *Time of making elections*—(1) *In general.* Any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) must be made on or before the later of-

(i) February 28, 1994; or

(ii) The due date (taking extensions into account) of the electing bank's original tax return for its disqualification year (as defined in §1.585–5(d)(1)) or, for elections under §1.585–6(d)(2),

the year for which the election is made.

(2) *No extension of time for payment.* Payments of tax due must be made in accordance with chapter 62 of the Internal Revenue Code. However, if an election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) is made or revoked on or before February 28, 1994 and the making or revoking of the election results in an underpayment of estimated tax (within the meaning of section 6655(a)) with respect to an installment of estimated tax due on or before the date the election was so made or revoked, no addition to tax will be imposed under section 6655(a) with respect to the amount of the underpayment attributable to the making or revoking of the election.

(b) *Manner of making elections*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, an electing bank must make any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) by attaching a statement to its tax return (or amended return) for its disqualification year or, for elections under §1.585–6(d)(2), the year for which the election is made. This statement must contain the following information:

(i) The name, address and taxpayer identification number of the electing bank;

(ii) The nature of the election being made (i.e., whether the election is to include in income more than 10 percent of the bank's net section 481(a) adjustment under §1.585–6 (b)(2) or (d)(2) or to use the cut-off method under §1.585–7); and

(iii) If the election is under §1.585–6(b)(2) or (d)(2), the percentage being elected.

(2) *Certain tax returns filed before December 29, 1993.* A bank is deemed to have made an election under §1.585–6(b)(2) or (d)(2) if the bank evidences its intent to make an election under section 585(c)(3)(A)(iii)(I) or section 585(c)(3)(B)(ii) for its disqualification year (or, for elections under §1.585–6(d)(2), the election year), by designating a specific recapture amount on its tax return or amended return for that year (or attaching a statement in accordance with §301.9100–7T(a)(3)(i) of this chapter), and the return is filed before December 29, 1993. A bank is deemed to have made an election under §1.585–7(a) if the bank evidences its intent to make an election under section 585(c)(4) for its disqualification year by attaching a statement in accordance with §301.9100–7T(a)(3)(i) of this chapter to its tax return or amended return for that year, and the return is filed before December 29, 1993.

(c) *Revocation of elections*—(1) *On or before final date for making election.* An election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) may be revoked without the consent of the Commissioner on or before the final date prescribed by paragraph (a)(1) of this section for making the election. To do so, the bank that made the election must file an amended tax return for its disqualification year (or, for elections under §1.585–6(d)(2), the year for which the election was made) and attach a statement that—

(i) Includes the bank's name, address and taxpayer identification number;

(ii) Identifies and withdraws the previous election; and

(iii) If the bank is making a new election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a), contains the information described in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section.

(2) *After final date for making election.* An election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) may be revoked only with the consent of the Commissioner after the final date prescribed by paragraph (a)(1) of this section for making the election. The Commissioner will grant this consent only in extraordinary circumstances.

(d) *Elections by banks that are members of parent-subsidiary controlled groups.* In the case of a bank that is a member of a parent-subsidiary controlled group (as defined in §1.585–5(d)(2)), any election under §1.585–6(b)(2), §1.585–6(d)(2) or §1.585–7(a) with respect to the bank is to be made separately by the bank. An election made by one member of such a group is not binding on any other member of the group.

(e) *Elections made or revoked by amended return on or before February 28, 1994.* This paragraph (e) applies to any election that a bank seeks to make under paragraph (b) of this section, or revoke under paragraph (c) of this section, by

means of an amended return that is filed on or before February 28, 1994. To make or revoke an election to which this paragraph (e) applies, a bank must file (before expiration of each applicable period of limitations under section 6501) this amended return and amended returns for all taxable years after the taxable year for which the election is made or revoked by amended return, to any extent necessary to report the bank's tax liability in a manner consistent with the making or revoking of the election by amended return.

[T.D. 8513, 58 FR 68764, Dec. 29, 1993; 59 FR 4583, Feb. 1, 1994; 59 FR 15502, Apr. 1, 1994]

§ 1.586–1 Reserve for losses on loans of small business investment companies, etc.

(a) *General rule.* As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a taxpayer which is a financial institution to which section 586 and this section apply is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of §1.166–1. In the case of such a taxpayer, the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under §1.586–2. A financial institution to which section 586 and this section apply which adopts the reserve method is not entitled to charge-off any bad debts pursuant to section 166(a) with respect to a loan (as defined in §1.586–2(c)(2)). Except as provided by §1.586–2, regarding the manner of computation of the addition to the reserve for bad debts, the reserve for bad debts of a financial institution to which this section applies shall be maintained in the same manner as is provided by section 166(c) and the regulations thereunder with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for bad debts of a financial institution to which section 586 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in §1.586–2(c)(2)), see section 166(a) and the regulations thereunder.

(b) *Application of section.* Section 586 and this section shall apply only to the following financial institutions:

(1) Any small business investment company operating under the Small Business Investment Act of 1958 as amended and supplemented (72 Stat. 689), and

(2) Any business development corporation, which for purposes of this section, means a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans which would generally not be made by banks (as defined in section 581 and the regulations thereunder) within such region or State in the ordinary course of their businesses (except on the basis of a partial participation), and which is operated primarily for such purposes.

[T.D. 7444, 41 FR 53482, Dec. 7, 1976]

§ 1.586–2 Addition to reserve.

(a) *General rule.* Except as provided by paragraph (b) of this section, the amount computed under this section is the amount necessary to increase the balance of the reserve for bad debts (as of the close of the taxable year) to the greater of:

(1) The amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such 6 or fewer taxable years, or

(2) The lower of:

(i) The balance of the reserve as of the close of the base year, or

(ii) If the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of